Office of Chief Counsel
Internal Revenue Service

memorandum

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date: DEC 18 2001

to: [redacted], Team Manager, Lakeland, Florida

from: Associate Area Counsel, Miami, Florida (LMSB)

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subject: [redacted]

This memorandum responds to your request for assistance. Kenneth D. Allison of International, Branch 4, was contacted in regard to the issues addressed in this memorandum. This memorandum should not be cited as precedent.

FACTS

On [redacted], the parent corporation of the [redacted] group of affiliated corporations ("[redacted]") was acquired by the [redacted] consolidated group ("taxpayer") in a stock for stock exchange. After the exchange, the [redacted] group became part of the [redacted] consolidated group.

[redacted], a Mexican corporation, was included as a section 1504(d) corporation on [redacted]'s consolidated return prior to the reorganization. [redacted] is a Mexican corporation and participates in Mexico's Maquiladora program. After the reorganization, [redacted] was included on the [redacted] consolidated return for the tax years ending June 30, [redacted], June 30, [redacted] and June 30, [redacted] pursuant to a section 1504(d) election (Forms 851 and 1122 were filed for [redacted] for each taxable year). After the reorganization, [redacted] was [redacted]% owned by [redacted], a U.S. corporation and a member of the [redacted] consolidated group. During the taxable year ending [redacted], [redacted] was liquidated into [redacted].

Taxpayer filed informal claims for refund for taxable years ending [redacted], [redacted], and [redacted]. Taxpayer seeks a refund of taxes paid on income of [redacted] included on the U.S.

consolidated return for each year. Taxpayer's basis for the claim is that [redacted] was improperly included on the U.S. consolidated return. Taxpayer cites PLR 8125143 as support for its proposition that [redacted] did not qualify as an includible corporation under section 1504(d).

ISSUES

1) Whether taxpayer may change its election whereby it included [redacted] on its consolidated return?
Conclusion: Yes. However, certain correlative adjustment need to be made to the consolidated returns filed for the [redacted], [redacted] and [redacted] taxable years.

2) Whether section 367(b) applies to the liquidation of [redacted] during [redacted]?
Conclusion: Yes.

DISCUSSION

1) Whether taxpayer may change its election whereby it included [redacted] on its consolidated return?

Under certain circumstances, a corporation incorporated in a contiguous country may be included on a consolidated U.S. tax return pursuant to section 1504(d). In order to qualify under section 1504(d), three requirements must be satisfied: 1) the foreign corporation must be organized under the laws of a contiguous country; 2) a domestic corporation must own or control, directly or indirectly 100% of the capital stock of the foreign corporation;[1] and 3) the ownership or control of the stock is **maintained solely for the purpose of complying with the laws of such country as to title and operation of property**. Section 1504(d). A domestic corporation complies with the requirement where "but for" incorporating in Mexico or Canada, the domestic corporation would not have been allowed to own or operate property in such country. U.S. Padding Corp. v. Commissioner, 865 F. 2d 750 (6th Cir. 1989). The benefit received from a "maquiladora status" in Mexico does not qualify as "property" within the meaning of Section 1504(d). See PLR 8125143 (March 27, 1981). Therefore,

[1]Note that the 100% ownership requirement is more limiting than the 80% vote and 80% value test in section 1504.

incorporation in Mexico in order to participate in the Maquiladora program does not satisfy the section 1504(d) requirements.

In our facts, taxpayer is attempting to disavow the section 1504(d) election and back out the income included on the [redacted] consolidated return for the [redacted], [redacted] and [redacted] tax years. Assuming that one of the purposes for incorporating in Mexico was to participate in the Maquiladora program, taxpayer's position that [redacted] does not qualify for section 1504(d) treatment is correct. Therefore, it must be determined whether non-qualification under section 1504(d) is a basis for disavowing the election.

Doctrine of Election

The Doctrine of Election generally binds a person to its initial choice, where the person had an equal right to choose one or more alternatives. See Roy H. Park Broadcasting, Inc. v. Commissioner, 78 T.C. 1093, 1134 (1982)(Once a taxpayer makes an elective choice, "he is stuck with it"); see also Pacific Nat'l Co. v. Welch, 304 U.S. 191 (1938)(where a taxpayer makes a conscious election under the tax laws, he may not, without the consent of the Commissioner, revoke or amend its election). The Doctrine of Election applies where: 1) there is a free choice between two or more alternative; and 2) there is an overt act by the taxpayer communicating the choice to the Commissioner. Bayley v. Commissioner, 35 T.C. 288, 298 (1960).

The following rationales for the Doctrine of Election have been articulated: 1) preventing administrative burdens and inconvenience in administering the tax laws, particularly when the new method chosen requires a recalculation of tax liability for several taxable years or for other taxpayers; 2) protecting against loss of revenues by preventing taxpayers from using the benefit of hindsight to choose the most advantageous method of reporting; 3) promoting consistent accounting practice, thereby securing uniformity in the collection of revenue; and 4) providing an equitable and fair tax system by treating similarly situated taxpayers consistently. See J.E. Riley Inv. Co. v. Commissioner, 311 U.S. 55, 59 (1940).

Oversight, poor judgement, ignorance of the law,

misunderstanding of the law, unawareness of the consequences of making an election, have all been held insufficient to mitigate the binding effect of elections made under a variety of provisions of the code. Grynberg,83 T.C. 255, 262 (1984). However, courts have recognized that a material mistake of fact may vitiate the binding nature of the election. See Grynberg v. Commissioner,83 T.C. 255 (1984).

Situations where a taxpayer may be permitted to change affirmative elections made on their federal tax returns (i.e. exceptions to the doctrine of election) include where: 1) the amended return was filed prior to the date prescribed for filing the original return; 2) the taxpayer's treatment of the contested item in the amended was not inconsistent with his treatment of the item in his original return; or 3) the taxpayer's treatment of the item in the original return was improper and the taxpayer elected one of several allowable alternatives in the amended return. See Goldstone v. Commissioner, 65 T.C. 113, 116 (1975). In Foley v. Commissioner, 56 T.C. 765 (1971), the taxpayer attempted to adopt, on an amended return, a declining balance method of depreciation after he adopted a straight line method on his original return. The Tax Court held that since the straight line method was not an erroneous selection of a legally unavailable method, the taxpayer was unable to revoke the original election without the consent of the Commissioner.

In our facts, taxpayer had the choice to include or not include [redacted] on its consolidated return. Taxpayer chose to include [redacted] on its consolidated return and filed Forms 851 and 1122 for each taxable year. Since taxpayer had a choice between two or more alternatives and communicated its choice to the Commissioner, the Doctrine of Election would apply to the section 1504(d) election, unless it falls under one of the exceptions enumerated above.

As discussed above, participation in the Maquiladora program in Mexico does not qualify [redacted] as an includible corporation under section 1504(d). See LTR 8125143. Therefore, electing to include [redacted] on the original U.S. consolidated returns pursuant to section 1504(d) was an "erroneous selection of a legally unavailable method". Since taxpayer's treatment of the item in the original return was improper, taxpayer is permitted to revoke the section

1504(d) election on amended returns for [redacted], [redacted] and [redacted] and not include [redacted] on the returns. See Goldstone v. Commissioner, 65 T.C. 113, 116 (1975). Therefore, taxpayer is entitled to back out the taxable income of [redacted] included on the [redacted], [redacted] and [redacted] consolidated returns.

Correlative Adjustments

Since [redacted] was a member of taxpayer's [redacted], [redacted] and [redacted] consolidated group, certain tax attributes of [redacted] were included on the consolidated return for each year. Therefore, in addition to removing the taxable income of [redacted] from the [redacted], [redacted] and [redacted] consolidated returns, other adjustments need to be made on the returns to reflect that [redacted] is not a member of the group. The following is a discussion of some of the areas to which adjustments may be needed:

1. Foreign Tax Credits.

The amount of the foreign tax credit allowed to a consolidated group for taxes paid or accrued during the consolidated return year to foreign countries or possessions of the United States is computed on a consolidated basis. Treas. Reg. 1.1502-4. Section 904 provides the rules for determining the amount of credits against U.S. tax under section 901(a) that may be taken for foreign taxes paid. Section 904(a) provides, "[t]he total amount of the credit taken under section 901(a) shall not exceed the same proportion of the tax against which such credit is taken which the taxpayer's taxable income from sources without the United States bears to his entire taxable income for the same taxable year." A separate limitation is calculated for each type of income provided in section 904(d).

An affiliated group calculates its foreign tax credit limitations on a consolidated basis. The limitations for each type of income for a consolidated group is:

The aggregate taxable income from all foreign sources of the group in the applicable basket/consolidated taxable income as determined under §1.1502-11 X U.S. consolidated tax on world wide income.

Direct and indirect expenses must be apportioned to either the U.S. source or the foreign source income in each income basket before the foreign tax credit limitation can be determined. Section 904(a). Indirect expenses and interest expense must be allocated as if all the members of an affiliated group were one corporation. Sections 864(e)(1) and 864(e)(6).

In our facts, any foreign tax credits taken by the group for foreign taxes paid by [redacted] must be removed from the returns. Any income of [redacted] included in the section 904(d) baskets must be removed and the consolidated group's foreign tax credit limitation for each basket needs to be recalculated. Furthermore, any expenses of [redacted] allocated to the foreign and U.S. source income of the consolidated group pursuant to sections 864(e)(1) and (e)(6) must be removed prior to a recalculation of the group's foreign tax credit limitations. Please note, The consolidated group would be entitled to deemed paid credits under section 902 or 960 on an actual or deemed dividend from [redacted] for creditable foreign taxes paid by [redacted].

2. Losses of [redacted].

As discussed above, [redacted] generated net taxable income reported on the consolidated return. However, it should be determined whether [redacted] incurred losses in any of the section 904(d)(1) baskets. A taxpayer is required to compute its taxable income (or losses) for each separate section 904(d) basket. Section 904(f)(5) provides that the amount of "separate limitation losses" for any taxable year shall reduce income from sources within the U.S. for such taxable year only to the extent the aggregate amount of such losses exceeds the aggregate amount of the separate limitation incomes for such taxable year. Section 904(f)(5). "Income category" means each separate category of income described in section 904(d)(1). Section 904(f)(5)(E)(i). "Separate limitation income" means, with respect to any "income category", the taxable income from sources outside the U.S., separately computed for such category. Section 904(f)(5)(E)(ii). "Separate limitation loss" means, with respect to any income category, the loss from such category. Section 904(f)(5)(E)(iii).

Consolidated groups are subject to the overall foreign loss

rules of section 904(f). Treas. Reg. 1.1502-9(a). Each consolidated group must maintain a consolidated overall foreign loss account and a separate notional overall foreign loss account must be maintained for each member of the consolidated group. Treas. Reg. 1.1502-9(b). The overall foreign loss rules of section 904(f), including section 904(f)(5), are applied on a consolidated basis. Therefore, any losses of [redacted] attributable to any of the "income categories" should be removed. The removal of such losses would increase the section 904 limitation of the consolidated group in such basket and/or reduce the offset of income in other baskets.

3. Controlled Foreign Corporation Status.

[redacted] is no longer treated as a U.S. corporation. Since it is a foreign corporation and is 100% owned by a "U.S. shareholder", [redacted] constitutes a "controlled foreign corporation" pursuant to section 957(a). As a "United States Shareholder", taxpayer is required to include in gross income its pro rata share of [redacted]'s subpart F income, if any, earned during [redacted], [redacted] and [redacted] (and subsequent taxable years). Section 951(a). In addition, taxpayer is required to file a Form 5471 ("Information Return of U.S. Persons With Respect to Certain Foreign Corporations") with regards to its ownership in [redacted].

4. Earnings and Profits of [redacted].

Since [redacted] constitutes a controlled foreign corporation, its earnings and profits must be computed for purposes of the subpart F rules, the section 959 distribution ordering rules and other provisions. A controlled foreign corporation must compute its earnings and profits in its "functional currency".[2] Temp. Treas. 1.964-1T(g)(1)(i). The earnings and profits are then translated into U.S. dollars at the spot rate in effect on the date that a dividend or deemed dividend is included in income. Section 989(b).

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[2]"Functional currency" is defined in section 985(b), in part, as the currency of the economic environment in which a significant part of a "business units" activities are conducted.

The earnings and profits of [redacted] backed out of the consolidated group's income should be treated as untaxed earnings and profits of [redacted] under section 959(a)(unless taxpayer is subject to tax on such earnings under section 951 during [redacted], [redacted] and [redacted]) and maintained in [redacted]'s functional currency. This ensures that any later repatriation of such earnings into the U.S. is treated as a taxable distribution after applying the ordering rules of section 959(c).

5. Property owned by [redacted].

Any depreciation or amortization deductions claimed on the [redacted], [redacted] and [redacted] consolidated returns for the depreciation or amortization of property owned by [redacted] must be removed from such returns. Please note, in the Maquiladora industry, the U.S. shareholder generally retains title to operating assets used in the production plants of the Mexican subsidiary. The Service generally permits the U.S. shareholder to claim depreciation or amortization deductions for such assets employed at the plants. Therefore, no adjustments are necessary for depreciation or amortization deductions taken during [redacted], [redacted] and [redacted] for assets owned by taxpayer. Please note, taxpayer is required to compute the depreciation deduction under the alternative depreciation system pursuant to section 168(g)(2) for any tangible property that is used predominantly outside the U.S. during the taxable year.

LIQUIDATION OF [redacted]

During the taxable year ending [redacted], [redacted] was liquidated into [redacted], its U.S. parent. As discussed above, taxpayer included [redacted] on its consolidated return for the tax years [redacted], [redacted] and [redacted] pursuant to a section 1504(d) election. Since [redacted] was treated as a U.S. corporation when the [redacted] return was filed, taxpayer did not apply section 367 to the liquidation. As such, no gain or loss was recognized on the liquidation pursuant to sections 332 and 337. Since [redacted] is no longer treated by taxpayer as a member of the consolidated return and is therefore treated as a foreign corporation, section 367(b) has implications on the liquidation of [redacted] into its U.S. parent during [redacted].

Section 367(b)(1) provides that, **except as provided in the regulations**, a foreign corporation is considered a corporation in the case of an exchange described in section 332, 351, 354, 355, 356 or 361 to which there is no transfer of property described in section 367(a)(1). Section 367(b)(2) provides that such regulations include provisions determining when gain shall be recognized in connection with a sale or exchange of stock of a foreign corporation by a United States person. Temp. Treas. Reg. 7.367(b)-5 applies to the transactions during [redacted]. The regulations provide two options to a domestic corporation which receives a section 332 liquidation of a foreign corporation.

1) Include "all earnings and profits" amount in income.

If the domestic corporation includes in income the "all earnings and profits amount" attributable to its stock in the foreign corporation, then the foreign corporation is treated as a "corporation" for purposes of subchapter C. Temp. Treas. Reg. 7.367(b)-5(b). As such, section 332 would apply in preventing the recognition of gain on the liquidation. Please note, the amount required to be included in income ("all earnings and profits amount") is not limited to the amount of gain realized on the liquidation.

The "all earnings and profits amount" means the net positive earnings and profits determined according to principles substantially similar to those applicable to domestic corporations. Treas. Reg. 1.367(b)-2(d). However, amounts included in income of a U.S. shareholder under section 951 ("previously taxes earnings and profits") are excluded from the "all earnings and profits amount". See Treas. Reg. 1.367(b)-2(d)(2)(ii); section 1248(d).

The "all earnings and profits" amount included in income is treated as a dividend for purposes of the I.R.C. Treas. Reg. 1.367(b)-2(e)(2). Therefore, the U.S. shareholder may be entitled to an indirect foreign tax credit under section 902 for any foreign taxes imposed on the "all earnings and profits" amount included in income.

For section 332 to apply, in addition to including the "all earnings and profits amount" in income, the regulations require that the domestic corporation file a notice with the Service. The notice must be filed on or before the last date

(including extensions) for filing a federal income tax return for the taxable year in which the corporation realizes gain. Temp. Treas. Reg. 7.367(b)-1(c)(1).

2) Taxable Exchange.

The domestic corporation may choose not to include the "all earnings and profits" amount in income. In such a case, the foreign corporation is not treated as a "corporation" for purposes of determining the extent to which gain is recognized on the exchange. Temp. Treas. Reg. 7.367(b)-5(b). Therefore, section 332 does not apply and the domestic corporation recognizes all of the gain realized on the receipt of property from the foreign corporation pursuant to section 1001. Although section 332 would not apply, section 337 would still apply to the liquidating foreign corporation. Temp. Treas. Reg. 7.367(b)-5(b). Please note, section 367(b) does not apply to any losses realized by the U.S. shareholder on the liquidation. Therefore, section 332 would still apply preventing the recognition of any losses realized.

The gain recognized will generally be treated as a gain from the sale or exchange of a capital asset. However, section 1248 may apply and treat some or all of the gain realized in the liquidation as a dividend. Section 1248(a) applies to a U.S. person who owns, or has owned, 10 percent or more of the voting stock of a foreign corporation at some time during the five-year period ending on the date of the sale or exchange. Section 1248(a)(2). In addition, the minimum stock ownership must have existed on a day on which the foreign corporation was a "controlled foreign corporation" as defined in section 957. Id.

The amount of dividend income under section 1248(a) can not exceed the shareholder's gain on the sale. Section 1248(a)(2). Section 1248(a) treats the gain from the sale or exchange of a foreign corporation as dividend income to the extent of the "section 1248 amount". The "section 1248 amount" is the earnings and profits of the foreign corporation that 1) are attributable to the stock sold or exchanged by the shareholder; 2) were accumulated in taxable years of the foreign corporation starting after 1962; 3) were accumulated while the U.S. person held the stock that is being sold or exchanged; and 4) were accumulated while the foreign corporation was a controlled foreign corporation. Section

1248(a)(2).

The "section 1248 amount" with respect to the U.S. shareholder may include the earnings and profits with respect to lower tier foreign corporations. Section 1248(c)(2). Section 1248(d)(4)(B) excludes from earnings and profits any item includible in gross income of the foreign corporation as effectively connected with the conduct of a U.S. trade or business. Section 1248(d)(1) excludes from earnings and profits any earnings and profits attributable to such stock sold or exchanged which were included in income as a subpart F inclusion under section 951. A gain treated as a dividend pursuant to section 1248(a) may trigger a deemed paid foreign tax credit under section 902. Treas. Reg. 1.1248-1(d).

In our facts, taxpayer did not elect to include the "all earnings and profits" amount in income by the due date of the [redacted] tax return pursuant to temp. treas. reg. 7.367(b)-1(c)(1) (since [redacted] was treated by taxpayer as a domestic corporation and therefore taxpayer did not apply section 367(b)). Therefore, section 332 does not apply and taxpayer is required to recognize any gain realized on the liquidation. Taxpayer owned 100% of [redacted] since [redacted], therefore, section 1248 may treat some or all of the gain recognized as a dividend, but only up to the amount realized.

As discussed above, earnings and profits of [redacted] earned during the [redacted], [redacted] and [redacted] taxable years should be backed out of the income reported on the consolidated return for each of the respective years. Such amounts should be treated as untaxed earnings and profits of [redacted] for purposes of section 959. The earnings and profits were earned while [redacted] was a controlled foreign corporation and were earned while taxpayer owned the stock of [redacted]. Therefore, such earnings and profits should be included in the "section 1248 amount" attributable to taxpayer's stock in [redacted]. As such, taxpayer is required to treat any gain recognized on the liquidation as a dividend up to the "section 1248 amount". The character of any remaining gain would be treated as a gain from the sale or exchange of a capital asset. Furthermore, taxpayer may be entitled to deemed paid credits for all or a portion of any creditable foreign taxes paid by [redacted] for the portion of the gain

treated as a dividend (including foreign taxes for which foreign tax credits were removed from the [redacted], [redacted] and [redacted] consolidated returns as provided above).

As discussed above, the earnings and profits removed from the U.S. consolidated return must be maintained in the "functional currency" of [redacted]. The earnings and profits must be translated back into U.S. dollars at the spot rate in effect on the date that a dividend or deemed dividend is included in income, i.e., date of the liquidation. Section 989(b).

Source of Any Gain Recognized

The source of any gain treated as a dividend pursuant to section 1248 is governed by the dividend source rules, not under the rules governing income form the sale of personal property. See section 865(k)(1). Generally, dividends received from a foreign corporation is foreign source income. See 862(a)(2). However, section 861(a)(2)(B) treats a portion of a foreign corporation's dividends as U.S. source if 25 percent or more of the corporation's gross income from all sources was effectively connected with the conduct of a trade or business in the U.S. Taxpayer would not be entitled to any deemed paid foreign tax credits under section 902 for any portion of the "section 1248 amount" treated as U.S. source.

Section 865(a) provides the general rule that the income generated from the sale or exchange of personal property is sourced in accordance with seller's country of residence. Therefore, the source of any remaining gain would be U.S. source income.

Foreign Currency Gain or Loss on Liquidation

A foreign currency gain or loss may result from the distribution to taxpayer of any "previously taxed" earnings and profits of [redacted] resulting from the liquidation.
Income included under section 951 is translated at the weighted average exchange rate for the CFC's taxable year. Section 989(b)(3). Where distributions of previously taxed earnings and profits (such as amounts included in income under section 951(a) and excluded from income when actually distributed pursuant to section 959(a)) are made, foreign

currency gain or loss attributable to movements in exchange rates between the time of the deemed (section 951(a) inclusion) and actual distributions shall be recognized and treated as ordinary income or loss from the same source as the associated income inclusion. Section 986(c)(1).

Where a United States person is required to include the "section 1248 amount" in gross income under treas. reg. 1.367(b)-5, such shareholder shall be treated as receiving, immediately prior to the exchange, a distribution of previously taxed earnings and profits attributable to its stock in the foreign corporation solely for the purpose of computing gain or loss under section 986(c). Treas. Reg. 1.367(b)-2(j)(2)(i). Therefore, although previously taxed earnings and profits are not included in the "section 1248 amount", such earnings and profits are treated as distributed for purposes of determining foreign currency gain or loss to reflect the movement in exchange rates between the time of the deemed inclusion (such as a section 951(a) inclusion) and the liquidation.

This advisory opinion is being sent to the National Office for a ten (10) day Significant Advice Review. If you have any questions please contact attorney Tamara Moravia-Israel at (305)982-5319 or Anthony Ammirato at (973)645-2539.

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